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Hong Kong's New Crypto Regulatory Framework to Facilitate Greater Institutional Participation

Regulators released comprehensive guidance to banks, intermediaries, and insurers on virtual asset-related activities.

Key Points:

- Banks and intermediaries looking to provide distribution, dealing, and advisory services in connection with virtual assets now have a comprehensive and actionable regime that can be used to solicit customers looking to increase their exposure to crypto.
- Banks and insurers seeking to deal with virtual assets on a proprietary basis or as part of their banking or insurance products now have guidance on how virtual assets should be treated from a prudential and risk perspective.
- Banks and intermediaries may partner with Hong Kong-licensed virtual asset trading platforms only. For unlicensed or overseas virtual asset trading platforms, this stipulation may be the impetus needed to acquire a license in Hong Kong.

Introduction

On 28 January 2022, Hong Kong's principal financial services regulators issued much-anticipated guidance to banks, securities firms, and insurers looking to undertake activities related to virtual assets (VAs). In particular:

- The Hong Kong Monetary Authority (HKMA) issued a [circular](#) to banks on "Regulatory approaches to Authorized Institutions' interface with Virtual Assets and Virtual Asset Service Providers" (HKMA Circular).
- The HKMA and the Securities and Futures Commission (SFC) issued a [joint circular](#) to banks and SFC-licensed intermediaries on "Intermediaries' Virtual Asset-Related Activities" (Joint Circular).
- The Insurance Authority (IA) issued a [circular](#) to insurers on "Regulatory Approaches of the Insurance Authority in Relation to Virtual Assets and Virtual Asset Service Providers" (IA Circular).

The guidance caps a flurry of activity in the VA space and ties together various pieces of the existing regulatory regime for VAs. To recap, in 2020, the SFC licensed its first VA trading platform under its [opt-in regime](#) (see Latham's [blog post](#)); further trading platforms are expected to be licensed shortly. In 2021, the Financial Services and the Treasury Bureau (FSTB) issued [consultation conclusions](#) on implementing a regulatory regime for VA service providers (see Latham's [blog post](#)) (FSTB Proposal). Most recently, on 12 January 2022, the HKMA issued a [discussion paper](#) on cryptoassets and stablecoins (see Latham's [blog post](#)).

With the guidance, financial services industry participants can move towards engaging in VA proprietary investments and client services. The guidance will also impact existing crypto firms, as the regulators stressed that financial services intermediaries are required to use SFC-licensed VA trading platforms. For those not already licensed or seeking to be licensed, this stipulation may serve as the impetus to obtain a license in order to serve Hong Kong customers.

A New Regime for Intermediaries' VA-Related Activities

In the Joint Circular, the HKMA and the SFC noted interest from intermediaries on distributing VA-related products and providing VA dealing and advisory services. For banks and intermediaries that wish to provide these services, the following regime will now apply (and, where relevant, supersede existing guidance). Intermediaries providing existing VA-related activities to clients will have a six-month transition period before the full implementation of the expected requirements in the Joint Circular.

Intermediaries should notify the SFC (and the HKMA, where applicable) in advance if they intend to engage in VA-related activities.

VA-related product distribution

VA-related products are likely to be considered "complex products" under the SFC's existing complex products regime, meaning that intermediaries are required to comply with additional investor protection requirements. For those distributing VA-related products, these additional requirements include the following:

- **Professional investor-only / selling restrictions:** Products should only be offered to "professional investors". One exception is for a limited suite of VA-related derivative products and funds that are traded on regulated exchanges specified by the SFC and, in the case of exchange-traded VA derivative funds, approved for offering to retail investors in the relevant jurisdiction — these products can be distributed to retail investors subject to the protections outlined below. Part IV of the Securities and Futures Ordinance (SFO), which regulates the offer of investments in Hong Kong will continue to apply. Therefore, the restrictions on offering investment products to the Hong Kong retail public will need to be considered.
- **Know-your-client procedures and VA knowledge tests:** For clients other than institutional investors and certain qualified corporate professional investors, intermediaries should assess whether clients have knowledge of investing in VAs or VA-related products (e.g., such knowledge can be acquired through training, work experience, or prior trading experience (at least five VA transactions in the preceding three years)). If not, the intermediary should assess whether it is acting in the client's best interest and provide the requisite training.
- **Suitability obligation:** Irrespective of whether there has been a solicitation or recommendation, intermediaries should ensure the suitability of VA-related products, where applicable. Intermediaries should consider whether the aggregate amount to be invested is reasonable considering the client's

net worth, and whether the client can assume the risks and bear the losses. One exception is for the limited suite of VA-related derivative products mentioned above. In the absence of solicitation or recommendation, intermediaries may distribute these products without needing to comply with the suitability requirement but still must conduct the requisite know-your-client procedures.

- **Derivative products:** When dealing with VA derivative products, intermediaries are required to conduct additional know-your-client procedures, including an assessment of the client’s knowledge of derivatives and whether the client has the financial resources to assume the risks involved.
- **Due diligence:** Intermediaries must conduct proper due diligence on VA products to understand their risks and features. For unauthorised VA funds, this means assessing the fund’s constitution, fund manager, operations, investment universe, custody practices, and service providers, among other categories.
- **Disclosure to clients:** Intermediaries should provide adequate disclosure to clients about VA product features and the risks involved.
- **Financial accommodation:** Intermediaries should be cautious in providing any financial accommodation. They should not accept instructions unless they can assure themselves that the client has the financial capacity to meet the obligations arising from leveraged or margin trading in VA-related products, including in a worst-case scenario.

VA dealing services

For intermediaries interested in providing VA dealing services to clients, the following requirements will be imposed by way of conditions on their license or registration:

- **Dealing license:** VA dealing services should be carried out by Type 1 (dealing in securities) intermediaries only.
- **SFC-licensed VA trading platforms only:** Intermediaries are required to partner with SFC-licensed VA trading platforms (or “SFC-licensed platforms”) to provide VA dealing services, either by way of acting as introducing agent (where the intermediary only has an introducing role and clients will thereafter directly trade on the platform), or by way of the intermediary establishing an omnibus account with the platform (so the intermediary can act as agent on behalf of the client to execute instructions). As of now, an “SFC-licensed platform” means a VA trading platform operator licensed by the SFC pursuant to Section 116 of the SFO (i.e., an exchange that facilitates trading in VAs that are characterised as “securities” and non-security VAs). Currently, there is only one SFC-licensed platform, but a number of license applicants are in the pipeline. The new regime underscores the significance of the VA trading platform licensing regime, and the authors of this *Client Alert* expect the SFC to grant more licenses in the coming months.

Notably, the definition of an SFC-licensed platform does not include VA exchange operators that will be licensed by the SFC in the future under the FSTB Proposal (i.e., exchanges that facilitate trading in non-security VAs only). Whether VA exchange operators were not included because the regime has yet to be implemented, or whether VA exchanges were purposely excluded, is unclear.

Professional investor only: VA dealing services should only be provided to “professional investors”. This condition is consistent with the SFC’s policy for SFC-licensed platforms and for VA exchanges.

The effect is that retail investors will continue to be excluded from regulatory protections, while professional investors will be subject to the safeguards under the new regime.

Notably, the definition of a professional investor is tied to the value of a person's portfolio of cash and securities but does not include the value of any VAs in the portfolio. During previous VA-related consultations, a number of industry participants have encouraged the SFC to consider revising the professional investor definition to include VAs as eligible investments for the purposes of qualifying as a professional investor.

- **Introducing agent services:** Intermediaries acting as an introducing agent should only introduce “professional investor” clients to SFC-licensed platforms. They are not permitted to relay any client orders or hold client assets. Further, they should enter into a written agreement that clarifies the nature of the services provided.
- **Omnibus arrangement:** Intermediaries providing VA dealing services under an omnibus account arrangement will need to adhere to specific terms and conditions that will be imposed as license conditions to the intermediary's Type 1 license or registration. Some of the requirements include the following:
 - *Same business, same risks, same rules:* The SFC's existing regime applicable to dealing in financial products and the conduct of regulated activities will generally apply to an intermediary's VA dealing activities.
 - *Financial soundness:* An SFC-licensed corporation should maintain in Hong Kong at all times excess liquid capital equivalent to at least 12 months of its actual operating expenses calculated on a rolling basis, in addition to its usual requirements under the Securities and Futures (Financial Resources) Rules.
 - *Omnibus arrangement:* An intermediary should only establish and maintain an omnibus account (designated as a trust or client account) with an SFC-licensed platform. All transactions for a client should be executed on that platform.
 - *Fiat-only deposits and withdrawals:* Clients will only be permitted to deposit and withdraw fiat currencies from their account. This requirement means that clients cannot deposit or withdraw VAs into their accounts held with the intermediary.
 - *Financial accommodation:* Intermediaries and their group companies should not provide any financial accommodation to acquire VAs. They should only trade if the client has sufficient fiat currencies or VAs to cover the trade.
 - *Know-your-client:* Intermediaries should have knowledge about the identity of the client on behalf of whom they act. For clients other than institutional investors and certain qualified corporate professional investors, intermediaries should assess whether clients have knowledge of investing in VAs or VA-related products. If not, the intermediary should provide the requisite training.
 - *Suitability obligation:* Intermediaries should ensure the suitability of the VA-related products (taking into account the client's net worth and profile). Intermediaries should also enter into a written client agreement with each client (other than for institutional investors and certain qualified corporate professional investors) and include a contractual suitability provision in the agreement.

- *Risk disclosure:* Intermediaries should fully disclose the nature and risks of trading VAs and the scope of their VA activities to the client.
- *Risk controls:* Intermediaries should (i) establish controls and procedures to monitor for market manipulation, (ii) set trading and position limits with reference to a client's financial situation, and (iii) ensure they do not trade in respect of jurisdictions that have banned VAs.
- *Statements, client assets, and recordkeeping:* Intermediaries are required to provide statements, protect client assets, and keep records adopting a similar approach to the existing securities regime.
- *Conflicts of interest:* An intermediary should not engage in VA market making activities on an SFC-licensed platform through which it provides client VA dealing activities.

VA advisory services

Intermediaries interested in providing VA advisory services to clients will be subject to the following requirements by way of conditions on their license or registration:

- **Professional-investor only:** VA advisory services should only be provided to “professional investors”. As mentioned above, this condition is consistent with the SFC's policy that VAs are not suitable for retail investors.
- **Same business, same risks, same rules:** The SFC's existing regime applicable to advising on financial products and the conduct of regulated activities will generally apply to an intermediary's VA advisory activities.
- **Know-your-client:** For clients other than institutional investors and certain qualified corporate professional investors, intermediaries should assess whether clients have knowledge of investing in VAs or VA-related products. If not, the intermediary should provide the requisite training.
- **Suitability obligation:** Intermediaries should ensure the suitability of the VA-related products (taking into account the client's net worth and ability to bear the potential losses). Intermediaries should enter into a written client agreement with each client (other than for institutional investors and certain qualified corporate professional investors) and include a contractual suitability provision in the agreement.

VA asset management services

Type 9 (asset management) intermediaries that provide VA discretionary account management services will continue to be subject to the [Proforma Terms and Conditions for Licensed Corporations which Manage Portfolios that Invest in Virtual Assets](#) issued by the SFC in October 2019.

Type 1 intermediaries that only provide discretionary account management services on an ancillary basis should only invest less than 10% of the gross asset value of the client's portfolio in VAs.

Guidance to Banks on VAs and VASPs

The HKMA Circular provides further guidance to banks looking to engage in VAs and virtual asset service providers (VASPs). The HKMA will adopt a risk-based approach to supervising banks' VA activities and expects banks to identify and understand the associated risks before engaging in any VA activities.

The HKMA does not currently intend to prohibit banks from incurring financial exposures to VAs, such as through investment in VAs, lending against VAs as collateral, or allowing their customers to use credit cards or other payment services to acquire VAs. However, banks will need to have adequate risk-management controls and conduct appropriate due diligence on VAs.

Banks should critically evaluate their exposures to different types of risks and put in place appropriate risk-mitigation measures, such as setting prudent limits on the institution's overall exposures to VAs and applying conservative loan-to-value ratios for VAs accepted as collateral. Further guidance is expected from a prudential perspective after the Basel Committee publishes the conclusions to its [consultation](#) on prudential treatment of cryptoasset exposures.

Banks are expected to pay extra attention when they become aware of customers engaging in VA-related activities. They should understand the nature of these transactions and, where applicable, file suspicious transaction reports to the Hong Kong Joint Financial Intelligence Unit in accordance with relevant legal and regulatory requirements.

Banks establishing relationships with VASPs should adopt a risk-based approach. Depending on the nature of the relationship, banks may need to undertake additional customer due diligence measures such as collecting information of the VASP's business, determining whether the VASP is subject to appropriate regulatory standards, and assessing the AML/CFT controls and risks.

Banks are expected to discuss with the HKMA (and other regulators when appropriate) and obtain the HKMA's feedback on the adequacy of the institution's risk-management controls before launching relevant VA products or services.

Guidance to Insurers on VAs and VASPs

The IA Circular provides further guidance to insurers on how they can discharge their regulatory obligations when dealing with VAs and VASPs. In particular, they should review the IA's [Guideline on Enterprise Risk Management](#) (GL21) in evaluating and addressing risks associated with VA-related activities. Insurers should identify and consider the risks (including AML/CFT and cyber risks) involved in such activities and establish monitoring and reporting processes to ensure that the relevant material risks are considered and conveyed to senior management.

Insurers are expected to adopt a conservative approach and should deduct the value of VAs in full when deriving their solvency positions. In addition, insurers carrying on general business should not include VAs as local assets when determining compliance with their obligation to maintain required assets in Hong Kong arising from their general insurance business.

Insurers looking to accept VAs as premium or provide coverage or benefits related to VAs should refer to the IA's [Guideline on Corporate Governance of Authorized Insurers](#) (GL10) when designing the product to ensure the policy is appropriate for the customer. Suitable training should be provided to insurance intermediaries so that customers are informed about the nature and risks of the product (and adequate disclosure should be provided in this regard). For insurers providing services to policyholders outside Hong Kong on VAs and VASPs, additional care is necessary to ensure all applicable laws and regulations are followed.

Insurers contemplating VA activities are strongly advised to inform and obtain advice from the IA on the adequacy of their risk-management controls before launching any new products or services (including forming any type of relationship with VASPs).

Next Steps

As consumer interest continues to grow in the VA space, the guidance from the regulators creates a common framework through which traditional financial stakeholders can engage with VAs and VASPs.

The list of actionable items is long, and includes:

- Preparing materials that meet the institution's new product approval policy and seeking consent from the relevant stakeholders and committees
- Establishing new policies and procedures to comply with the legal and regulatory expectations
- Drafting compliant customer terms and conditions
- Conducting diligence on VA products to determine risks and categorisation
- Preparing and reviewing risk disclosures for distributed VA products
- Conducting appropriate know-your-client procedures on existing and potential clients to determine their suitability for VA products
- Preparing or partnering with external parties to conduct VA training for clients
- Conducting due diligence on VASPs to determine whether they meet the regulatory standards
- Engaging and establishing partnerships with SFC-licensed platforms for omnibus and introducing agent services

Since the regime is effective immediately, interested parties who have prepared their business plans and proposed internal controls can contact their regulators to kick-start the process of launching new products and business lines. For VA dealing and advising activities, this process will involve applying to the SFC for the relevant terms and conditions to be imposed as licensing/registration conditions to the intermediary's Type 1 and Type 4 licenses. Intermediaries providing existing VA-related activities to clients will have a six-month transition period to put in place procedures to comply with the new regime before the full implementation of the Joint Circular requirements.

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